

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:HAR:B:TL-N-6659-00
MIRoot

date: December 20, 2000

to: Territory Manager (LM:FSH)
Christopher Lappano
Michael Fox

from: Associate Area Counsel (CC:LM:FSH:HAR:B)

subject: [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Taxable Years - [REDACTED]

DISCLOSURE STATEMENT

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DISCUSSION

This is in response to your (telephonic and facsimile) request for assistance in the above-captioned matter. Generally, you sought our review of a closing agreement (drafted by the

taxpayer) providing for the redetermination of commissions paid in [REDACTED] and [REDACTED], but which by means of the closing agreement, would relate to the taxable year [REDACTED] (when paid). Set forth below are the facts giving rise to this opinion.

Facts

Presently, the Internal Revenue Service is examining the tax returns for the taxable years ending [REDACTED] and [REDACTED] of [REDACTED]. (" [REDACTED] ") and [REDACTED] [REDACTED]. (" [REDACTED] ").

[REDACTED] was incorporated [REDACTED]. It elected to be treated as a DISC (under section 992(b)¹) on [REDACTED]. It qualifies as a DISC under section 992(a)(1).

During [REDACTED] and [REDACTED], [REDACTED] as the related supplier paid commissions to [REDACTED]. They seek a redetermination (pursuant to Treas. Reg. §1.994-1(e)(4)) of those commissions.

If the aforementioned redetermination is permitted and results in additional commissions being paid by [REDACTED] to [REDACTED], it is [REDACTED]'s intent to make distributions to its shareholders of such amounts.

[REDACTED] filed an informal claim with the Internal Revenue Service's audit team on [REDACTED] for its [REDACTED] year. The informal claim asserted a deduction for commissions paid to [REDACTED] in the amount of approximately \$ [REDACTED]. As the statute of limitations on refund was to expire [REDACTED], [REDACTED] claimed a refund of \$ [REDACTED] with the correct amount to be subsequently determined on audit.

[REDACTED] indicated that it would be making similar assertions for its [REDACTED] year on an amended [REDACTED] corporate return. Discussions ensued between the Service, the taxpayers and their representatives concerning the benefits of deducting the redetermined commissions on [REDACTED]'s [REDACTED] tax return rather than on amended [REDACTED] and [REDACTED] returns.

[REDACTED] had in excess of [REDACTED] shareholders for both [REDACTED] and [REDACTED]. Therefore, these [REDACTED] shareholders will each have to file an amended income tax return in both [REDACTED] and [REDACTED] reporting as dividend income the actual (or deemed) distributions

¹ All statutory references are to the Internal Revenue Code in effect during the years at issue unless otherwise noted.

resulting from the redetermination of the commissions to be paid by [REDACTED] to [REDACTED].

The parties recognized the burden on all involved taxpayers and the Service of such a large number amended returns. The parties wish to avoid this burden. Thus, they would like to enter into a closing agreement, generally treating the payment of the redetermined commissions, and subsequent distributions as taking place in the taxable year ending [REDACTED], rather than in [REDACTED] and [REDACTED].

To that end, the taxpayers have drafted a closing agreement which among other things, provides: (a) for the redetermination of the commissions paid by [REDACTED] to [REDACTED] in [REDACTED] and [REDACTED]; (b) that such redeterminations will be reported as taxable events in the taxable year ending [REDACTED]; (c) that the redetermined commissions actually be paid by [REDACTED] to [REDACTED] in the taxable year ending [REDACTED]; (d) that [REDACTED] will make distribution payments of the full amount of the increased commission income to the shareholders of record as of the end of [REDACTED] and [REDACTED] in [REDACTED]; (e) that [REDACTED] will report the distributions payments to its shareholders of records (as of [REDACTED] and [REDACTED]) as occurring in the taxable year ending [REDACTED] (rather than [REDACTED] and [REDACTED]); (f) that [REDACTED] will be allowed a deduction for the payment of the redetermined commissions in the taxable year ending [REDACTED] (rather than the [REDACTED] and [REDACTED] taxable years); (g) the Service will allow an increase in [REDACTED]'s commission income for the amount of the redetermined commissions and allow a corresponding increase in the deemed distributions under section 995(b)(2); (h) the Service will consider the trade receivable representing the increased DISC commission to be considered a qualified export asset for purposes of section 992(a)(1)(B) and regulations 1.993-2(a), 1.993-2(d)(2) and (3) and 1.994-1(e)(4) and (5) for the taxable years [REDACTED] and [REDACTED] if applicable.

It was the Internal Revenue Service's understanding that it would be entitled to examine [REDACTED]'s entitlement to the deduction for payment of the increased commission.

These facts give rise to the following issues.

Issues

1. Whether the payment of a redetermined commission under Treas. Reg. § 1.994-1(e)(4) can be treated as occurring in the year of payment (or establishment), rather than the taxable

year(s) in which the transaction(s) occurred which gave rise to said commission?

2. Whether the Internal Revenue Service will accept the redetermination of a commission under Treas. Reg. § 1.994-1(e)(4) for a taxable year in which the assessment of additional tax resulting from the distribution of such redetermined commission is prohibited by the expiration of the statute of limitations?

Analysis

Issue 1

Typically, a business forms a Domestic International Sales Corporation ("DISC") through which it channels its export activities. If the DISC is selling merchandise, it will either buy products from the related supplier (buy-sell DISC) or act as a commission agent for the related supplier (commission DISC).

To avoid problems of section 482 and to encourage use of DISCs, section 994 provides special rules that can guide the setting of prices between the related supplier and its DISC. Section 994's inter-company pricing rules apply to commissions paid by the related supplier to the DISC. Section 994(b).

After a DISC has filed its return, a redetermination of the commission paid it (under section 994), is permissible in certain circumstances. Treas. Reg. § 1.994-1(e)(4). Such redetermination may only be made if permitted by the Code and corresponding regulations. Id. Such redetermination would include a redetermination by reason of an adjustment under section 482 and its regulations or section 861 and § 1.861-8 which affects the amounts which entered into the determination of the commission. Id.

If the commission for a transaction determined under section 994 is different from the commission actually charged, the person who received too small a commission shall establish (or be deemed to have established), at the date of the determination or redetermination (under Treas. Reg. § 1.994-1(e)(4)) of the commission under section 994, an account receivable. Treas. Reg. § 1.994-1(e)(5)(i)(a). The receivable is equal to the difference in amount between the commission so determined and the commission previously paid and received. Id.

If the account receivable due the DISC is paid within 90 days after its establishment (or deemed establishment), it "shall" be treated as an asset and, under Treas. Reg. § 1.993-

2(d)(3), as a trade receivable, and thus as a qualified export asset, as of the "end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness". Treas. Reg. § 1.994-1(e)(5)(i)(a). It will not relate to the taxable year during which it is established or paid. Treas. Reg. § 1.994-1(e)(5)(i)(b).

If the account receivable due the DISC is not paid within 90 days after its establishment (or deemed establishment), it is treated as an asset which is not a qualified export asset (under § 1.993-2(d)(3)). Treas. Reg. § 1.994-1(e)(5)(i)(b)(iii). Nevertheless, in such case, it still will be considered to relate to the taxable year in which the transaction occurred. Treas. Reg. § 994-1(e)(6), Example 2.

In the case at bar, the taxpayer and its DISC have sought to redetermine the commissions due the DISC for the years ending [REDACTED] and [REDACTED]. Upon payment of the redetermined commissions (per § 1.994-1(e)(5)), the taxpayer wishes the account receivable paid, to relate, not to [REDACTED] and [REDACTED], but to the year [REDACTED]. This treatment is in direct contravention of Treas. Reg. § 1.994-1(e)(5)(i)(a) and (b). See also Treas. Reg. § 1.994-1(e)(6), Examples 1, 2.

A redetermination of the commission payable to a DISC is made upon an amended return (if, as noted above, it is otherwise allowable under the Code and regulations). Rev. Rul. 82-81, 1982-1 C.B. 109. The fact that the redetermination is made upon an amended return is further indication that the commission is to be given effect in the year(s) in which the transaction(s) originally occurred and not some year for which a return has not been filed. In this case, [REDACTED] and [REDACTED], and not [REDACTED].

In conclusion, the payment of a redetermined commission under Treas. Reg. § 1.994-1(e)(4) is not treated as occurring in the year of payment (or establishment). Rather, it is given effect in the taxable year(s) in which the transaction(s) occurred which gave rise to the commission in the first place. Therefore, if the taxpayer and its DISC (are permitted to redetermine) the commissions payable to the DISC for [REDACTED] and [REDACTED], those redetermined commissions must relate to [REDACTED] and [REDACTED], and not [REDACTED].

Issue 2

As noted above, DISC shareholders are taxed on the earnings and profits of the DISC (with certain modifications). Section 995(a). The DISC shareholders are deemed to have received a

distribution which is taxable as a dividend from the DISC. Section 995(b). These distributions are deemed to be received by the DISC shareholders on the last day of the taxable year of the DISC in which the income was derived. Id.

It was concluded above, that [REDACTED] would "derive" income from [REDACTED]'s payment of the redetermined commissions in ([REDACTED]'s) taxable years ending [REDACTED] and [REDACTED]. Treas. Reg. § 1.994-1(e)(5)(i)(a) and (b); See also Treas. Reg. § 1.994-1(e)(6), Examples 1 and 2. The distributions by [REDACTED] to its shareholders, of the income from the redetermined commissions (taxable as a dividend), are deemed to be received by the shareholders on the last day of the taxable year of [REDACTED] in which the income was derived; namely [REDACTED] and [REDACTED]. Section 995(a) and (b).

The amount of any tax shall be assessed within three (3) years after the taxpayer files the return (except as otherwise provided). Section 6501(a). Under this provision, the term "return" means the return required to be filed by the taxpayer, and not a return of a person from whom the taxpayer has received an item of income. Id.

As noted above, [REDACTED] had in excess of [REDACTED] shareholders for each of its taxable years ending [REDACTED] and [REDACTED]. Generally, the majority of those shareholders, being individuals or trusts, would be required to file their income tax return by [REDACTED] see sections 6012(a), 6072(a). Accordingly, the general statute of limitations on assessment of tax, including tax on income from any distributions from [REDACTED], for such shareholders' [REDACTED] tax returns, would expire [REDACTED], unless otherwise provided. Section 6501(a). Thus, it would appear that the statute of limitations on assessment of tax from the deemed [REDACTED] distributions from [REDACTED] to its shareholders has expired (unless otherwise provided).

If the taxpayer's [REDACTED] return is false or fraudulent, or the taxpayer has willfully attempted to defeat or evade tax for the applicable year, then the statute of limitations would not bar assessment of tax resulting from [REDACTED]'s deemed dividend distribution for [REDACTED]. Section 6501(c)(1) and (2). If the taxpayer (DISC shareholder) has not filed a return for [REDACTED], then the assessment of tax resulting from [REDACTED]'s deemed dividend distribution for [REDACTED] would not be barred by the statute of limitations. Section 6501(c)(3). If the taxpayer and the Service have executed a consent to extend the period to assess taxes for [REDACTED] which is still in effect at the time of any proposed assessment, then the statute of limitations again would

not bar such assessment. Section 6501(c)(4). If the amount of the deemed dividend distribution exceeds 25% of the taxpayer's reported gross income, then the tax from such deemed distribution may be assessed within 6 years after the return was filed. Section 6501(e)(1).

No other provisions applicable to this case provide for extensions of the period for assessment of tax resulting from the deemed dividend distributions from [REDACTED] to its shareholders exist. Thus, unless one of the grounds for such extensions in sections 6501(c)(1), (2), (3), (4) or 6501(e) apply, the period for assessment for the [REDACTED] year has expired. Furthermore, the period for assessment of the [REDACTED] liabilities will expire [REDACTED].

A redetermination of the commission payable to a DISC is made upon an amended return, if, as noted above, it is otherwise allowable under the Code and regulations. Rev. Rul. 82-81, 1982-1 C.B. 109. The treatment of amended returns is a matter of the internal administration of the Internal Revenue Service, solely within the discretion of its Commissioner. Miskovsky v. Commissioner, 414 F.2d 954, 955 (3d Cir. 1969). Neither the Internal Revenue Code, nor the Treasury Regulations make any provision for the acceptance of an amended return in place of the original return previously filed. Koch v. Alexander, 561 F.2d 1115, 1117 (4th Cir. 1977); Evans Cooperage Co., Inc. v. United States, 712 F.2d 199, 204 (5th Cir. 1983).

Since the Internal Revenue Service has the discretion to accept or reject an amended return, it could reject the amended returns providing for an increased commission to the DISC, which are distributed to the DISC shareholders, because the statute of limitations on assessment of any additional tax from those distributions have passed. (b)(7)a, (b)(2)Low
[REDACTED]

It is our opinion that an amended return providing for redetermination of a commission under section 994 should not be accepted, when the payment of that redetermined commission would result in a deduction, but the income resulting from that redetermination will escape taxation.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum

incorporating any such recommendation.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later. If you have any questions regarding this matter please contact me at (716) 551-5610.

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Attorney